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CORPORATE GOVERNANCE — A MOVING TARGET

Robert L. Knauss*

Six years ago, Professor Alfred Conard did a shocking piece of research. He marshalled quantitative data and basic arithmetic to demonstrate that all corporations are not alike. In his article, *The Corporate Census: A Preliminary Exploration*,¹ Professor Conard described the broad range of sizes of business corporations in the United States, and suggested that corporation law must be tailored to these differences. Unfortunately, Professor Conard's advice has been too often ignored. Most commentators still look to the largest, publicly traded corporations for their models of corporate governance; they still fail to acknowledge that problems and appropriate solutions may vary with corporate size.

This Essay elaborates on Professor Conard's sensible suggestion with the hope that others will take it to heart. First, the Essay discusses the unique governance problems raised by what I call quasi-publicly traded corporations. These smaller corporations, whose shares are not actively traded, have been largely neglected in most discussions of corporate governance. The neglect is ironic since most state corporation statutes were originally designed with the quasi-publicly traded corporation in mind. Second, the Essay turns to a problem of corporate governance common to all corporations — the proper role of directors — and shows that appropriate standards may vary with the type of corporation at issue. It concludes that the director's role is best defined in terms of flexible common-law concepts of fiduciary duties. Together, the discussions of quasi-publicly traded corporations and fiduciary duties of directors show that corporate governance is not a static concept; it is rather a moving target, shifting with the regulatory problems of different sized corporations.

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1. Conard, *The Corporate Census: A Preliminary Exploration*, 63 CALIF. L. REV. 440 (1975), reprinted in A. CONARD, *CORPORATIONS IN PERSPECTIVE* 94 (1976).

I. THE QUASI-PUBLICLY TRADED CORPORATION

Much of the current interest in corporate governance stems from a rediscovery of old issues. Reformers complain that state general corporation laws offer little real protection to shareholders, that many corporations are large economic centers of power yet are beyond the reach of state regulatory authorities, and that shareholders have less and less of a role in management. None of these complaints is new; all were first raised and debated nearly fifty years ago.² Current concern among the general public over the productivity,³ honesty,⁴ charity, social responsibility,⁵ and legitimacy⁶ of corporations has raised these issues once again.⁷ The concern extends beyond publicly held corporations to corporate entities that are formed for nonprofit purposes⁸ and to large privately controlled enti-

2. For a description of the debate, see A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); L. BRANDEIS, *OTHER PEOPLE'S MONEY* (1933); W. RIPLEY, *FROM MAIN STREET TO WALL STREET* (1932); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Berle, *For Whom Are Corporate Managers Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). The most complete bibliography of sources on corporate government appears in COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 557-74 (D. Schwartz ed. 1979).

3. Productivity involves the promotion of investment capital, and improvement in efficiency of the work force. The general public has a continuing interest in increased productivity, which includes encouragement of the migration of savings into investment, and rewarding of good business judgment. The promotion of investment capital is in the public interest, but it also reflects the shareholder's interest in obtaining a high return on his investment. The goal of maximizing profits thus is not the antithesis of public interest but is an important part of it.

4. The public has an interest in seeing corporations act honestly. This interest goes beyond the shareholder's concern for honest disclosure of information and avoidance of self-dealing by management.

5. The Business Roundtable recently identified four functions of the board of directors of the large publicly owned corporations: (1) management selection and succession, (2) approval of corporate decisions which have a major economic impact, (3) corporate social responsibility, and (4) compliance with the law. See BUSINESS ROUNDTABLE, *THE ROLE AND COMPOSITION OF THE BOARD OF DIRECTORS OF THE LARGE PUBLICLY OWNED CORPORATION* 8-15 (1978), reprinted in 33 BUS. LAW. 2083 (1978).

6. The legitimacy of corporate management is brought into issue because of the lack of shareholder control over management activities. But the concern goes beyond selection of managers. Managers making decisions affecting the larger community are apt to be as important as elected city or state government officials. The public interest, then, is both in the process of selection, and the accountability of those individuals who are selected. See Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327 (1979); Hurst, *The Legitimacy of the Business Corporation*, in *LAWS OF THE UNITED STATES 1780-1970* (1970).

7. One common element in approaching these issues is the fiduciary responsibility of directors discussed in section II of this Article.

8. The nonprofit corporation should also be considered in the context of public interest in corporate governance. Although only a few nonprofit corporations are as large as the giant business corporations, they dominate some fields and some communities.

For example, health care delivery is dependent on the private not-for-profit hospitals. Approximately 3,400 of the nation's 6,000 hospitals are nonprofit corporations, and these hospitals account for 80% of total hospital revenues of \$62 billion. At least a dozen of these private nonprofit hospitals have over \$100 million in revenues. Hospitals are usually non-membership

ties that are centers of economic power.⁹

Individual investors have much more specific concerns than those of the general public.¹⁰ They are primarily interested in obtaining accurate information so that they can continuously evaluate their investment and can act on that information by holding or selling the stock. An active market in the stock satisfies both of these needs for shareholders of publicly traded corporations. Federal securities regulations and market forces inspire publicly traded corporations to share information with the investing public. This sharing creates a high quality securities market which operates honestly and efficiently: prices are not distorted by manipulation; short-term price swings are minimized; insider trading is controlled; and orders are handled fairly, at a low price. The trading market protects dissatisfied investors, who can readily sell their shares. It also creates a degree of management accountability, since managers are keenly aware of the market price of the company's shares.¹¹

Ideally, state corporation laws would offer investors in shares of corporations that are not actively traded an effective substitute for the market's information and liquidity by requiring disclosure of useful information and by mandating corporate behavior that substitutes for investor liquidity. Unfortunately, current state laws fail to

corporations, which means that the directors are selected by the existing board. See SENATE SUBCOMM. ON HEALTH AND THE ENVIRONMENT, 96TH CONG., 1ST SESS., U.S. HOSPITALS REVENUE REPORTS 1976-1977 (Comm. Print 1979).

9. By using several sources a rough composite comparison of private corporations can be made to the public business corporations in the Fortune 500. See note 16 *infra*. It is estimated that at least 50 privately held corporations, 60 foreign-owned corporations, and at least 15 employee or farm cooperatives each had over \$600 million in annual revenue. See CORPORATE DATA EXCHANGE, INC., CDE STOCK OWNERSHIP DIRECTORY, AGRIBUSINESS (1978). These 125 entities would comprise about 25% of the Fortune 500 list if they were included. By a similar comparison about 32 private corporations, 33 foreign owned corporations and 11 cooperatives had over \$900 million in revenues, and would comprise about 15% of the Forbes list of the largest publicly traded corporations of all types.

None of these entities is affected by any of the SEC proposals concerning corporate governance, and none would be affected by any of the current legislative proposals involving federal incorporation.

10. The typical investor has been described as: (1) leaving all decisions within the ordinary course of business to management; (2) desiring an opportunity to vote for management, and any significant change in management structure; (3) desiring an opportunity to vote for any fundamental changes in corporate structure, or decisions, made outside the ordinary course of business; (4) desiring an opportunity to remove the investment from the corporation if the investor dissents from any fundamental change in the business. To this list should be added an expectation of receiving information about his investment, and the right to protect his investment both by maintaining voting power and by preventing dilution of the investment. Thus, the investor expects to be able to make decisions about the evaluation of the investment, but not in the actual management of the investment. See M. EISENBERG, THE STRUCTURE OF THE CORPORATION 9-17, 64-68 (1976).

11. See Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 402 (1977).

offer any meaningful regulation. Information is usually inadequate, and shareholder interests are frequently unprotected. Protecting the investor in the quasi-public corporation therefore poses a considerable challenge to students of corporate governance.

A. *Defining the Quasi-Publicly Traded Corporation*

Because of the overriding importance of liquidity to an investor, I will classify corporations according to the existence of active markets for their shares. The existence of a marketplace for shares changes the fundamental relationship of the shareholder to the corporation. The ability to trade at any time provides the shareholder a flexibility comparable to the partner's right of dissolution. The degree of liquidity determines the importance of structural formalities in a corporation and of accountability from officers and directors.

The key category that I will examine is composed of what I have been calling the "quasi-publicly traded corporations." This category includes some 100,000 corporations with between eleven and 499 shareholders each.¹² The public shareholders of such companies are not involved in active management. The shares are freely transferable, and both management and investors expect that the corporation will continue to operate indefinitely. These corporations are not close corporations, nor are they incorporated partnerships. They are public corporations in every sense except that there is no active market for the shares. The lack of an active market means that the sale price for shares may have little relation to their value, and that shareholders in these corporations, unlike investors in publicly traded corporations, do not have a liquid investment.

The category of the quasi-publicly traded corporation is flanked by groups of larger and smaller corporations whose shareholders have varying regulatory needs because of differing levels of liquidity. At one end of the spectrum are some 1,900,000 small business corporations which each have between one and ten shareholders.¹³ In this

12. This is an estimate. Professor Conard in his earlier study listed 71,000 companies with between 11 and 100 shareholders and 13,000 with between 101 and 1,000 shareholders — for a total of 84,000 with between 11 and 1,000. This was based on a total corporate population of 1.6 million. See Conard, *supra* note 1, at 458, table 6. Professor Eisenberg, also using a base of 1.6 million corporations, estimated that there are 70,000 corporations with between 11 and 99 shareholders, and 26,500 with between 11 and 499 shareholders. M. EISENBERG, *supra* note 10, at 42, table 5.

13. These include one-person corporations, wholly owned subsidiaries, and a wide variety of business entities, most of which can be described as incorporated partnerships. A substantial number of these corporate entities are involved in relatively little, if any, business activity, and many exist for only a short duration. Included in this category are the approximately 360,000 companies which file Subchapter S income tax returns allowing the shareholders to be taxed as a partnership.

category, investors generally are involved in management, and there is no shareholder intent at the time of purchase ever to trade the shares. Liquidity is usually assured by some contractual arrangement, or by a right to dissolution.¹⁴ Thus the regulatory needs and desires of very small corporations and their shareholders are far different from those in the quasi-publicly traded corporation category.¹⁵

At the other end of the spectrum are the huge¹⁶ and not-so-huge corporations whose shareholders have access to an active market. Although some two million corporations filed corporate income tax returns in 1975,¹⁷ relatively few have issued shares that are actively traded in a secondary market. Estimates of the number of publicly traded companies vary, but a rough approximation would include

14. Shareholders in these small corporations may find themselves locked into their investment in a manner similar to shareholders in the quasi-publicly traded corporation, but there are important differences. In corporations with less than ten shareholders all parties are frequently involved in management, and have access to management information. Many of these corporations are intended to operate like partnerships, and shareholders may have dissolution rights similar to those of partners. The initial plan of incorporation and the shareholder agreement frequently contain buy-out provisions. The most significant distinction, however, is in the reasonable expectation of the shareholder. The shareholder of an enterprise with less than ten investors knows he is locked into his investment unless some special provisions are taken.

15. This is not to say that the regulation of small corporations could not, or should not, be improved. The corporations with ten shareholders should be given an option in their method of regulation. A close corporation statute with the flexibility to allow a company to operate like a partnership should be provided. The concept is that shares are *not* transferable, and the investment relationship is based on a contractual relationship. To the extent a company elects not to use close corporation provisions, statutory requirements for the quasi-publicly traded corporation should apply.

16. "The Fortune 500" has achieved the status of a collective noun defining the giant corporations. The list of the largest U.S. industrial corporations is ranked by revenues. In May 1980 the largest corporation, Exxon, had \$79 billion in revenues, and the 500th corporation had \$409 million. See *The Fortune Directory of the 500 Largest Industrial Corporations*, FORTUNE, May 5, 1980, at 274-301. The Fortune Second 500 ranged from \$409 million in revenues to \$117 million. See FORTUNE, June 16, 1980, at 176-95.

A more recent entry in the ranking game is the Forbes-Dimensions of American Business. See FORBES, May 12, 1980, at 214-18. Forbes ranks the 500 largest publicly traded corporations, including utilities and financial institutions, in four separate categories: revenues, assets, net profits, and market value. Two-hundred-fifty-four corporations are in the top 500 in all four categories, and a total of 801 corporations are listed in one of the four categories. The ranges for sales and assets are as follows:

Rank	Revenues	Assets
1	\$79 billion	\$113.0 billion
500	\$409 million	\$1.4 billion

Seventy-eight companies had revenues of over \$5 billion and 265 had revenues of over \$2 billion. The largest 15 corporations had combined revenues of over \$500 billion, which is larger than the total revenues of the federal government. The over two million corporations had combined revenues of about \$3.606 trillion. Twenty-three percent of the corporations had revenues less than \$25,000, forty-four percent less than \$100,000, and eighty-eight percent less than \$1 million.

17. INTERNAL REVENUE SERVICE, DEPT. OF TREASURY, NO. 16 (2-80), STATISTICS OF INCOME . . . 1975, CORPORATION INCOME TAX RETURNS 106, table II (1979).

about 6,500 companies that have equity securities held by more than 500 shareholders and that are subject to the reporting, proxy, and insider trading requirements of the Securities Exchange Act of 1934.¹⁸

Some commentators have mistakenly criticized the "race to the bottom" in state corporation laws for creating problems of governance in publicly traded corporations. Such an analysis misses the mark. The statutory changes which have taken place in Delaware, New Jersey, and other "liberal" jurisdictions have not been particularly detrimental to the minority shareholder of the publicly traded corporation. Regulation of publicly traded corporations remains appropriately (and successfully) focused at the federal level.¹⁹ The real problem with state general corporation laws lies in their failure to distinguish between corporations whose shares are actively traded and corporations whose shares are not.

B. *Regulating the Quasi-Publicly Traded Corporation*

It is appropriate for states to regulate quasi-publicly traded corporations because the needed type of regulation has traditionally been found in state corporation laws. State laws can have a significant impact because of both the relatively small size of these corporations and their tendency, unlike the larger publicly traded

18. Some 9,800 issuers are required to file annual reports with the Securities and Exchange Commission. See SECURITIES AND EXCHANGE COMM., DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION, at 1 (1980). The Directory includes all issuers listed on a national securities exchange, and all others required to file under §§ 12(g) and 15(d) of the Exchange Act of 1934. This list includes a significant number of stock purchase plans and other entities which duplicate the separate corporate listing. The Securities and Exchange Commission reports that about 6,500 separate corporations submitted proxy statements, or proxy informational statements, for review. This may be a more meaningful figure representing separate corporate entities with equity securities. SECURITIES AND EXCHANGE COMM., ANNUAL REPORT 111 app. (1977). This was the last annual report which contained statistical information on issuers. This report also cited 6,798 securities listed on a registered stock exchange representing 3,283 separate issuers, and cited 2,627 issuers which were regularly quoted in the NASDAQ System. *Id.* at 311, 315.

19. The approximately 6,500 publicly traded corporations are subject to the regulatory provisions of the 1934 Exchange Act. All must file periodic reports, send information to shareholders at least once a year under the proxy provisions, and subject officers and directors to the insider trading provisions.

Historically the SEC has given priority to regulation of the initial distribution of securities under the 1933 Act. The primary purpose of the regulatory activity has been to protect investors from fraud, and is aimed at wrongdoing by issuers, licensed broker-dealers, accountants, lawyers, and other participants in the market place. During the past several years there has been a shift of emphasis to regulation of continuous disclosure and concern with the quality of the marketplace. In terms both of shareholder protection and the public interest this shift is proper and should be accelerated. Today, the highest priority of the SEC should be to promote the operation of the secondary trading markets.

The primary function for state regulation of the publicly traded corporation is to provide a forum for enforcing strong and consistent fiduciary duties on officers and directors.

corporations, to incorporate in the state where their principal place of business is located.²⁰ The need for greater state governance of quasi-publicly traded corporations is increased by the lack of federal controls. Companies in the quasi-public category are not registered under the Securities Exchange Act of 1934, and thus are not covered by federal disclosure, proxy, takeover bid, and insider trading regulations. If one views these provisions as designed to protect the trading markets, it is sensible that they would not apply to quasi-publicly traded corporations. Nevertheless, in many respects, it is the shareholders in these companies that have the greatest need for the direct regulatory protection offered by the 1934 Act. State law must pick up where the federal regulation stops.

State legislatures transformed their corporate regulations into enabling statutes to attract large corporations. And, indeed, aside from identifying fiduciary duties it is appropriate that state law be uninvolved in direct regulation of publicly traded corporations. But it is time to return to a regulatory orientation for the quasi-publicly traded corporation. States should begin with four reforms from which publicly traded corporations could be exempted: shareholder voting controls; preemptive stock purchasing rights; appraisal rights; and mandatory disclosure of information to shareholders.

First, state corporation statutes should require procedures that insure shareholder voting control. Shareholder voting rights are desirable not because they assure accountability (their primary virtue in the context of large publicly traded companies), but because they promote actual shareholder control. Shareholders in the quasi-publicly traded corporation cannot exercise their option under the "Wall Street Rule,"²¹ so they must be able to influence or change management and its policies in some other way when they are dissatisfied with the operation of their company. For companies with fewer than 500 shareholders, the shareholder meeting is usually the forum for actual voting. The proxy system can be critical, and state law should give a high priority to proxy regulation in order to insure fair and proper voting procedures. There is little need to require prior review of corporate proxy materials, but there should be rules punishing

20. See CAL. CORP. CODE § 2115 (West 1979). Under the provisions of the California Corporation Code, a state could invoke its jurisdiction over "foreign" corporations that have a significant nexus within the state.

21. For the past generation, the conventional wisdom has been that investors in publicly traded companies follow the "Wall Street Rule": if shareholders are dissatisfied with the company, their recourse is to sell their shares. Like much conventional wisdom, this is generally accurate. It is inaccurate in part because of the failure to recognize the number of publicly traded corporations in which stock is concentrated in large blocks, and because of employee stockholders who may be locked into their investment.

misleading statements or omissions, and investors should have easy access to shareholder lists. The various structural prohibitions which were a part of many state corporation acts should also be reconsidered. Our goal is to provide shareholders an opportunity to control management through the directors, so only shares with voting rights should be sold. Staggered terms for directors should be prevented, and other devices that restrict shareholder control should be prohibited. Cumulative voting should be allowed, because it assures some representation for minority shareholders who may be locked into their investment.

Second, shareholders in quasi-publicly traded corporations should have a preemptive right to purchase a pro rata share of the securities in any new stock issuance. Mandatory preemptive rights have disappeared from almost all state corporation acts because they offer stockholders of publicly traded companies unnecessary protection. But for quasi-publicly traded corporations, a well-drafted preemptive rights statute makes sense. Preemptive rights preserve both the investor's voting power and the value of his stock. Voting power is preserved because a shareholder who owns a percentage of shares would be able to retain the same percentage following any future issuance of stock by the company. Where no public market for the shares exists, a shareholder denied preemptive rights is unable to maintain his relative position of control. Preemptive rights also prevent dilution of share value. The lack of a trading market to establish value makes the setting of a price on a new distribution of stock a matter of guesswork, and even the good faith of the directors will not prevent dilution if there is no way to determine market value. Because preemptive rights permit the shareholder to retain ownership of the same percentage of outstanding shares before and after each new issuance, they prevent dilution of the value of the investment. Thus, while preemptive rights are of little or no value to a shareholder in a publicly traded corporation, they are essential to shareholders in a company whose shares are not actively traded.

Third, shareholders in quasi-publicly traded corporations should have limited appraisal rights. When the investor does not approve of fundamental change in the nature of the corporation, he should be able to obtain the cash value of his investment from the corporation. The appraisal right should be limited because the investor who purchases shares in a quasi-public corporation should know that his investment is not liquid and should not expect to be able to resell his shares to the corporation unless a specific contractual agreement provides for repurchase. Nevertheless, an investor in even a quasi-pub-

lic corporation has the reasonable expectation that it will continue in the same line of business and that it will operate under the same general structure. If a majority of the shareholders in a quasi-public corporation decides to make fundamental changes in the corporation — amendments to the articles of incorporation, sale of substantially all of the assets, or restructuring through merger or combination — a dissenter should have appraisal rights to protect his reasonable expectation.

Shareholders in publicly traded corporations have little reason to object to the recent changes in many corporation statutes which permit fundamental changes and amendments with a simple majority vote. The dissenting shareholder in a publicly traded company has little need for appraisal rights since he can sell his shares on the market.²² Similarly, dissatisfied shareholders in an incorporated partnership often have a contractual right to force a dissolution. But a dissenting shareholder in a quasi-publicly traded corporation has access to no trading market, and dissolution is not a fair or appropriate solution. In this situation statutory provisions providing for appraisal rights of dissenting shareholders are a reasonable answer. Appraisal rights provide the dissenting shareholders an option to maintain their investment in the new or altered enterprise or to receive the cash value of their investment. The use of the appraisal mechanism by the majority to squeeze out minority holders raises different questions involving the fiduciary responsibilities of the majority to the minority. The appraisal remedy should be viewed as a compromise that allows a substantial majority of existing shareholders to change the basic nature of the company if they want to, while at the same time assuring liquidity to the dissenters. The appraisal remedy should be rigorous enough to keep management from doing indirectly what it would be prohibited from doing directly. And because the appraisal remedy is analogous to a statutory buy-out agreement, it is appropriate to provide a period of time for payment in order not to force actual liquidation or dissolution of the company.

Finally, shareholders in quasi-publicly traded corporations should have a right to information about their investment. Corporations with fewer than 500 shareholders are not bound by federal reporting requirements, and in most states no laws adequately regulate financial disclosure to shareholders. Some economists have argued

22. For competing arguments about appraisal rights even in publicly traded companies, see M. EISENBERG, *supra* note 10, at 69-84, and Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962).

that because there is a market for information about publicly traded companies, the regulatory provisions of the federal securities laws play a rather modest role in disclosure of information by those companies. The marketplace itself forces disclosure when such companies attempt to sell securities to the public and when shares are actively traded in the secondary market. Without a marketplace there is no economic pressure for disclosure. After the time of initial investment, investors in a quasi-publicly traded company have little bargaining power to force the company to make periodic financial disclosures. For the publicly traded corporation, disclosure is needed if the marketplace is to evaluate the shares accurately. For the quasi-publicly traded company, disclosure is needed if the shareholders are to judge the progress of the company, evaluate management, and exercise their voting rights.

At a minimum, state regulations should entitle shareholders of quasi-publicly traded corporations to an annual report including financial statements, and should protect shareholders from false or misleading statements in a company's periodic reports, proxy literature, or other communications. This protection need not entail great expense; a rule similar to rule 242 of the 1933 Securities Act might be adopted. This rule would merely require that a corporation provide equivalent information to all investors — thereby assuring that all investors will share information that any one investor receives.

Together, these four reforms go a long way toward providing investors in quasi-publicly traded corporations the protection they need. State general corporation acts should be amended to apply these provisions, not to all corporations, but only to those corporations where the need is identified.

II. THE FIDUCIARY DUTIES OF DIRECTORS

Although it has attracted far more attention than has the quasi-publicly traded corporation, the search for the appropriate role for the corporate director remains the central problem of corporate governance. Traditional analysis focuses on the director's obligations of due care and loyalty, but understates the key feature of these obligations — that they are owed to the corporation. In this section I emphasize that the director should be viewed as a fiduciary to the corporate entity. The fiduciary concept clearly identifies the director's obligations to the corporation and permits flexibility in the director's role according to the nature of the enterprise.

The fiduciary duties of directors arise because property has been placed in their care. Directors have a responsibility to use that prop-

erty according to the terms of the corporate charter, the law, and the general requirements of good citizenship imposed on any owner of the property. Fiduciaries owe duties to a principal. Directors of large publicly traded corporations, small corporations, and nonprofit corporations all owe fiduciary duties to their corporation, and not to any particular corporate constituency.²³ Their specific responsibilities in complying with these duties will differ depending on the purpose and power of the corporations they serve. Directors of all corporations have a responsibility to use funds properly, not to waste corporate assets, to insure honest and efficient management, and to carry out the purposes of the corporate charter. The director or trustee of a private university makes decisions based on what is best for the university — the entity — and not for individual students or faculty. In the same way, a director of a business corporation makes decisions based on what is best for the entity, and not for the employees or even the individual shareholders. By comparing the responsibilities of the directors of publicly traded business corporations and nonprofit corporations, I do not mean to underestimate the importance of the profit-making purpose of business corporations, but rather to stress that the *entity* and the *corporate* purpose is the focus of a director's duties. Professor Dodd advocated a similar concept when he urged that directors should think of themselves not as attorneys for the investors, but as trustees for the enterprise.²⁴

Some commentators have recently criticized the use of the term "fiduciary" in defining directors' duties. The American Bar Association Committee on Corporations deliberately avoided the term in its redraft of section 35 on the Duty of Care in the Model Business Corporation Act.²⁵ This avoidance is a mistake. While Justice Frank-

23. A breach of fiduciary duty can be challenged only by a director's or shareholder's suit on behalf of the corporate entity. This emphasis is particularly important in the context of corporate governance and the claims made by various corporate constituencies.

24. See Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1160 (1932). There should be no presumption that consideration of the public interest will lead to a splintering of director responsibility. There is also no case law that indicates potential liability of directors for this approach. In *Dodge v. Ford Motor Co.*, 204 Mich. 459, 1970 N.W. 668 (1919), the court did admonish Henry Ford not to run the company for his own interests to the detriment of shareholders, but it supported the expenditures for long-range corporate development. But see Conard, *Reflections on Public Interest Directors*, 75 MICH. L. REV. 941, 947 (1977).

25. MODEL BUSINESS CORP. ACT § 35 (Comments on Amendments), reprinted in 33 BUS. LAW. 1631, 1634 (1978):

The committee took the view that those responsibilities of directors which are fiduciary in nature would be sufficiently comprehended in the affirmative standard proposed so as to make unnecessary the use of a term which represents the possibility of importing into the area of corporation law more than is appropriate of the attributes and obligations of a fiduciary as firmly established in the law of trusts.

On the other hand, Professor Coffee criticizes the use of the term because it is too narrow and

furter was correct in stating that the designation of a party as a "fiduciary" merely initiates the inquiry as to the specific obligations,²⁶ this does not mean that the designation is without value. The duties of directors of corporations have evolved through the common law, and have been built on the foundation of agency. In the early 1800s judges and lawyers were well aware that directors were fiduciaries.²⁷ The *Restatement Second of Agency* states that an agent is a fiduciary²⁸ and that members of boards of directors resemble agents in that they act on behalf of others and are *fiduciaries* owing duties of loyalty and care.²⁹ Although the contemporary corporate directorship involves complex relationships,³⁰ the decision-making process suffers if corporate lawyers attempt to invest the term "director" with a new set of duties unrelated to fiduciary concepts. This denies a rich and valuable heritage.

The fiduciary concept is of particular value today to counteract the influence of federal securities regulation on corporate law. For the past twenty years plaintiffs' attorneys have attempted to squeeze all varieties of director misconduct into the mold of breach of a duty to disclose and, therefore, breach of the federal securities laws. This emphasis has diminished directors' sensitivity to other aspects of their duties. The prohibitions of conflicts of interest and breach of due care and the requirements of fairness have taken second place. The recent unwillingness of the United States Supreme Court to sanction a federal corporation law under the securities acts³¹ has restored prominence to state remedies and created a need to rediscover traditional duties.

Under most state corporations statutes, directors have the responsibility to manage or direct the management of the corporation. To carry out this responsibility directors must discharge duties of care and of loyalty. When a corporation undertakes specific obligations, directors as fiduciaries to the corporation are required to use due care to insure that these obligations are performed. The director's

leads to "tunnel vision." See Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977).

26. SEC v. Chenery Corp., 318 U.S. 80, 85 (1943).

27. See E. DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860*, at 70-71 (1954).

28. RESTATEMENT (SECOND) OF AGENCY § 13 (1958).

29. "Members of boards resemble agents in that they act on behalf of others and are fiduciaries owing duties of loyalty and care." RESTATEMENT (SECOND) OF AGENCY § 14c, comment (1958).

30. For a thoughtful description of relationships, see Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976).

31. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Cort v. Ash, 422 U.S. 66 (1975).

duty of loyalty requires him to avoid conflicts of interest or to resolve them in the best interest of his corporation. Each of these traditional directors' duties — of care and of loyalty — is clarified by viewing the director as a fiduciary. This section describes these duties, and then turns to several remaining implications of applying the fiduciary concept to the corporate director.

A. *The Director's Duty of Care*

A contemporary approach to the director's duty of care can best be gleaned by reading the Model Business Corporation Act together with the business judgment rule, the *Corporate Director's Guidebook*,³² and several court decisions. Section 35 of the Model Business Corporation Act sets forth the basic corporate rule:

A director shall perform his duties as a director including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinary person in a like position would use under similar circumstances.

This section is a slightly wordier form of the standard of care in most jurisdictions in the United States, and closely resembles a typical fiduciary standard of care.³³ Even Delaware courts are reported to follow this standard, though the legislature has not adopted the MBCA language.³⁴

A short version of the business judgment rule is simply that a corporate transaction not involving a conflict of interest will not be subject to judicial inquiry if made in good faith.³⁵ Courts distinguish between inquiry into the procedure by which the directors reached

32. *Corporate Director's Guidebook*, 33 BUS. LAW. 1595 (1978).

33. Unless otherwise agreed, a paid agent is subject to a duty to a principal to act with standard care and skill which is standard in the locality for the kind of work for which he is employed to perform, and in addition, to exercise any special skill that he has.

RESTATEMENT (SECOND) OF AGENCY § 379 (1958). Compare the standard of care for an agent with that of a trustee in 1 RESTATEMENT (SECOND) OF TRUSTS § 174 (1959):

The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill.

The words are slightly rotated, but the thought remains the same in the standard of care described under ERISA:

. . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.

34. For an excellent discussion of § 35 of the MBCA in respect to Delaware law, see Arsh & Hinsey, *Codified Standard — Same Harbor but Charted Channel: A Response*, 35 BUS. LAW. 947 (1980).

35. For a longer version, see 35 BUS. LAW. at 956.

their decision, and an inquiry into the correctness of the decision.³⁶ The good faith requirement places a burden on directors to show how they reached the decision and what factors they considered. To demonstrate good faith the directors need show only that the decision was made on a reasonable basis under the circumstances.

The *Corporate Director's Guidebook* describes the duties and responsibilities of a director of a publicly traded corporation. The *Guidebook* also presents a recommended organizational model for the publicly traded company: a board with a majority of unaffiliated directors and a committee structure with nominating, compensation, and audit committees composed of unaffiliated directors. The *Guidebook's* recommended standards could quickly grow into legal requirements.³⁷ For example, a director of a publicly traded company might not be acting in good faith if a majority of his board members are "insiders." Similarly, if the board is organized without a series of committees, has no staffing assistance, and has no access to needed information, the director may not be acting in good faith.

Section 35 of the MBCA also contains a provision allowing a director to rely upon documents and statements made by others "whom the director reasonably believes to be reliable and competent." A recent supplement to the *Corporate Director's Guidebook* describes the role and function of the Audit Committee, and suggests an agenda, timetable, and procedures for an audit committee of a publicly traded company.³⁸ If one adds the suggestions in this guide to section 35, one acceptable pattern of an internal control system emerges. If followed, it should allow directors to rely on documents and statements prepared by the company officers. It is a description of due care which would permit the presumption that a director acts reasonably when he believes that an officer or employee is reliable and competent.

The courts have infrequently considered the director's proper duty of care to the corporate entity, but an analogy can be drawn from two securities cases. *Escott v. Barchris Construction Corporation*³⁹ contains the most complete discussion of director liability

36. A specific articulation of this approach to due care and the business judgment rule was made by the New York Court of Appeals in upholding a decision by directors to dismiss a shareholder's derivative suit. *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S. 920 (N.Y. 1979).

37. The *Corporate Director's Guidebook* applies only to publicly traded corporations. It is to be expected that different responsibilities and organizational patterns would apply to directors of other corporate entities.

38. ABA COMMITTEE ON CORP. LAWS, THE OVERVIEW COMMITTEE OF THE BOARD OF DIRECTORS, reprinted in 35 BUS. LAW. 1335, 1351 (1980).

39. 283 F. Supp. 643 (S.D.N.Y. 1968).

under section 11 of the Securities Act of 1933. The court held various directors liable to purchasers of securities during a public offering because, of material misstatements in the prospectus. The directors failed to prove the affirmative defense available to a director who shows that "he had after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true."⁴⁰ In a related case, *Lanza v. Drexel & Co.*,⁴¹ the plaintiffs alleged director responsibility for misstatements of corporate officers during a private merger transaction in violation of rule 10b-5 of the Securities Exchange Act of 1934, a common-law standard of care. The court found no liability. An analysis of these two cases in terms of strict liability, scienter, recklessness or negligence is not helpful. The focus should be on whether the director used such care as an ordinary prudent person would use in a public securities offering (*Barchris*) or in a private offering (*Lanza*). It is necessary in these circumstances to think not only of individual due care but also of the directors' collective duty. Did the directors organize the board structure to appropriately monitor a securities offering? Did they direct management on appropriate standards for release of information in connection with a stock offering? Did they develop appropriate internal auditing standards, and a check by an audit committee of the needed disclosure documents? Were these internal standards sufficient to allow the directors to rely on documents prepared by management?

The degree of care expected from a director of a publicly traded corporation has increased dramatically in the past decade. It would not be surprising for this growth to continue through the 1980s. What is considered prudent behavior for a director of a corporation should depend upon a thoughtful consideration of practical business considerations, as well as of questions of liability. The American Law Institute project on corporate governance should examine this approach through a Restatement of Fiduciary Duties of Directors.⁴²

B. *The Director's Duty of Loyalty*

No single statutory provision covers the subject of loyalty as comprehensively as section 35 of the MBCA covers due care. While almost all state corporation laws have provisions similar to section

40. Securities Act of 1933 § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1976).

41. 479 F.2d 1277 (2d Cir. 1973).

42. The American Law Institute has announced a project on Corporate Governance under the direction of Stanley Kaplan.

41 of the MBCA, which specifies procedures when a corporation enters into a contract in which a director has a private interest, these procedures address only one of a large number of loyalty duties. Section 41 of the MBCA has limited application even with respect to contracts between a director and a corporation. It prevents contracts from being void or voidable because a director is on one side of the agreement, if after disclosure there has been approval by a majority of the board of disinterested directors, or a vote of the shareholders, or if the contract is fair. Section 41 is silent on the potential for challenging a contract because of other conflicts of interest, or because of unfairness. In most state corporation acts, no statutory provisions cover corporate opportunity, use of confidential information, relationships between parent and subsidiary corporations, and the multitude of other conflict-of-interest situations which arise in a corporate setting. Traditional agency analysis is a helpful place to begin examining corporate conflict of interest. A brief description of the issues involved in four settings — corporate opportunity, insider trading, multiple directorships, and parent-subsidiary problems — demonstrates the value of identifying directors as fiduciaries to the corporate enterprise.

A classic corporate opportunity conflict-of-interest case arises when an officer-director hears about an investment opportunity because of his position, uses company resources to develop a product in the line of business of the corporation, does not give the company a chance to reject the opportunity, and then takes the product for his own private use.⁴³ One way to analyze this problem is to compare it to the way courts treat the conflict-of-interest dilemma in an individual agency situation. When there is a conflict between the agent's personal interest and the interest of the principal, the agent's duty is clear. The real estate agent who purchases land for himself when traveling on an employer's expense account must hold the land in constructive trust for his employer.⁴⁴ In addition to any remedy for breach of contract or damages in tort, the agent can be forced to disgorge any profits he made from the use of information or resources gained from his position even if the principal cannot prove any actual damages. Only *full disclosure* to the principal followed by his *consent* will allow an agent to profit from information or resources received from his agency position.

In the corporate setting, one difficulty is determining whether the

43. See *Guth v. Loft*, 23 Del. Ch. 255, 5 A.2d 503 (1939).

44. See, e.g., *Whitten v. Wright*, 206 Minn. 423, 289 N.W. 509 (1939).

agent has permission to use the opportunity. How is full disclosure made to the enterprise, and how does the enterprise give consent? It is usually assumed that since directors are responsible for the management of the corporation (or directing the management), disclosure to directors and receipt of their consent is sufficient to avoid liability. By analogy, provisions such as section 41 of the MBCA permit directors to obtain consent to their personal involvement in a contract with the corporation by disclosure and the vote of disinterested directors. In some situations, however, this is not an appropriate procedure because directors are incapable of giving consent. This problem can arise when a majority of the directors are involved in the transaction, or when the nature of the information or resources used has a direct effect on individual shareholders. An example of this latter situation is the use of inside information by officers and directors to trade in shares of the company.

Most insider trading cases have been based on allegations of fraud between individual purchasers and sellers, and have been brought under rule 10b-5 of the Securities Exchange Act of 1934.⁴⁵ An alternative approach that seems particularly appropriate to insider trading of the shares of publicly traded companies is to base the liability on the fiduciary duty of directors and employees not to use information gained on the job for personal profit. Unless there has been full disclosure to and consent by the corporation, any director or agent has a duty to disgorge any profits made from use of insider information. The duty does not rest on any showing of damage or loss. This approach was adopted by the New York Court of Appeals in *Diamond v. Oreamuno*,⁴⁶ but it has been rejected in Florida. The Florida Supreme Court has taken the position that directors do not owe any duties to individual shareholders, and that the insider trading must damage the corporation before the corporation can recover.⁴⁷ The Florida court missed the basic fiduciary remedy which would require disgorgement of profits regardless of any showing of damage.

Multiple directorships present a particularly difficult dilemma for the agency approach to corporate conflicts of interest.⁴⁸ The normal

45. Compare *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) with *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971).

46. 24 N.Y.2d 494, 248 N.E.2d 910, 401 N.Y.S.2d 78 (1969).

47. *Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975). This case involved a corporate officer as tippee, and direct profits were not shown. The court disavowed *Diamond v. Oreamuno*, however, stating that a derivative suit could not be brought unless there was a showing of damage to the corporation.

48. See, e.g., *Johnston v. Greene*, 35 Del. Ch. 479, 191 A.2d 919 (1956).

expectation in an agency relationship is that the agent will not serve competing clients. The exceptions — for example, the real estate broker who represents several sellers of property — are based on an assumption that the agent has made full disclosure of his conflict, and that the sellers have consented to their agent operating for competing parties.⁴⁹ If he acted without disclosure and consent, the real estate agent would violate his fiduciary duties. The parties also assume that the agent will treat each seller fairly, without any breach of confidential information. By analogy, the starting point for analyzing multiple directorships should be a prohibition against serving on boards of competing companies. The key to exceptions should be the expectation of shareholders of the competing corporate entities, the extent of the disclosure needed, and the nature of the consent.

The relationship of a parent corporation to minority shareholders of a subsidiary presents a fourth set of particularly difficult conflict-of-interest problems. The conflicts may be so fundamental that disclosure cannot cure them, and even if disclosure is capable of providing a remedy there remains the question of insuring effective shareholder consent. State corporation statutes similar to section 41 of the MBCA are not helpful. In the contract between a parent corporation and its subsidiary, the whole board of each corporation is an interested party. In effect the parent is negotiating on both sides of the agreement. In this situation it is also unrealistic to think in terms of any meaningful consent by shareholders of the subsidiary, because the parent corporation usually controls the overwhelming majority of the shares.

In *Sinclair Oil Corporation v. Levien*,⁵⁰ the Delaware Supreme Court recognized the fiduciary duty of a parent corporation to a subsidiary, but held that the duties applied only to transactions involving self-dealing, which it defined as transactions in which the parent receives something from the subsidiary to the exclusion and detriment of the minority shareholders of the subsidiary. If a transaction involves self-dealing, the court held, the test of intrinsic fairness shifts the burden of proof to the parent. In all other situations the usual business judgment rule was held to apply. The court failed to recognize that parent and subsidiary transactions always involve

49. See *Foley v. Mathias*, 211 Iowa 160, 233 N.W. 106 (1930).

50. 280 A.2d 717 (Del. 1971). *Sinclair Oil* involved a dispute between the minority shareholders of a subsidiary (Sinven), and the parent company (Sinclair). The complaint alleged the misdirection of corporate opportunity, payment of excessive dividends, and unfairness in contract negotiation. Sinclair owned 97% of the stock of Sinven, and nominated and elected all members of the board of Sinven, all of whom were officers and directors of Sinclair.

conflicts of interest, and are incapable of resolution by disclosure and consent of disinterested members of the board. A traditional agency approach would shift the burden of proof to the parent's directors in all transactions between a parent corporation and a subsidiary with minority shareholders. This rule is an appropriate starting place, but without more it could encourage corporations to squeeze out the minority shareholders of their subsidiaries. This would be unfortunate, because squeeze-outs can frequently work a hardship on shareholders. To protect shareholders from such hardships courts should consider the expectations of shareholders investing in subsidiaries, and the existence or lack of a trading market. Where a subsidiary must have minority shareholders (as is the case for many foreign subsidiaries) there should be guidelines for arms-length transactions and a standard for judging fairness.

The relationship of "due care," the "business judgment rule," and conflict of interest becomes extremely complex. The American Law Institute project on corporate governance can also perform a valuable service in this area. In particular, it can develop procedures for providing disclosure and obtaining consent that vary according to whether the corporation is publicly traded, privately held, or non-profit. I believe the best starting place for resolving these issues is the specific application of traditional fiduciary duties.

C. *The Director as a Fiduciary*

The emphasis on the fiduciary responsibility of directors to the entity also helps us address two other problems of corporate governance. First, the fiduciary concept helps to define the factors directors should consider in making decisions for the corporation. Second, the concept suggests a proper composition for the board.

The first problem — what factors a director should consider in decision-making — frequently arises when someone complains about the social irresponsibility of a corporation's decision (whether it be to lay off workers, to manufacture a controversial product, or its failure to make substantial charitable contributions). Corporate social responsibility is usually discussed in terms of a conflict in directors' duties. Are directors under a duty only to maximize profits for shareholders, or is it appropriate to consider the interests of employees, consumers, neighbors of corporate facilities, and members of the general public? The Business Roundtable identifies oversight of corporate social responsibility as one of the four main duties of direc-

tors.⁵¹ At the same time, it charges directors to "direct the enterprise in the interest of the owners, subject to constraints imposed by law." This apparent conflict is resolved by stressing the goal of long-term profitability rather than short-term profit maximization. The Roundtable opens the door to consideration of social responsibility by stating that long-term profitability is tied to the social viability of the corporation. By appealing to long-term profitability and the needs of future investors, directors are in less danger of criticism. Yet this solution is ultimately unsatisfying.

The question of what a director is entitled to consider in making a judgment affecting the corporation is brought sharply into focus in the takeover bid situation. When a bid at a substantial premium over current market price is made, directors must decide whether to endorse or fight the offer.⁵² It is natural for personal considerations to play a role in these decisions, and it can be argued that allowing directors to consider any interest other than immediate shareholder profit only provides a cover for decisions based on personal interests. Conflict-of-interest questions aside, however, is it in the public interest to allow directors to consider the impact of a takeover on employees, local communities, and the long-range development of the company? Do boards have to do what is best for the arbitragers and professional investors who hope to turn a quick profit? Do boards need to evaluate their corporations constantly to see if liquidation most benefits shareholders? Arguing long-term versus short-term profits is one way for directors to rationalize rejection of an immediate premium for existing shareholders. It provides an acceptable basis for boards to maintain the independence of the corporation. No one can object to a company's purchase of mineral reserves to be used twenty years later, development of a personnel plan to produce future executives, or investment in research and development which may have only a long-term return. Long-term profitability is a concept that makes sense, and allows directors important latitude in exercising their duty of care. But one should not be fooled by it. The concept legitimates consideration of the needs of future investors, and this implies that the corporate entity has a life of its own. A

51. See BUSINESS ROUNDTABLE, *supra* note 5.

52. A distinction should be made between a partial tender offer and a 100% takeover. In the partial takeover control will shift, but minority shareholders of the target remain. In this situation it is necessary for directors of the target company to investigate the honesty and competency of the bidding company. Long-range business plans are also important. It can be argued that in the 100% takeover situation the target management need look only to the question of adequacy of price.

more straightforward and accurate description of a director's duty is to identify the object of the duty as the enterprise itself.

Identifying the director's duty to the entity allows consideration of all factors which have a bearing on long-term benefit. Dissolution and liquidation may be appropriate if a corporation can no longer achieve its purpose, but directors do not constantly need to evaluate and base decisions on short-term return for investors. Duty to the entity also helps identify directors' general duties of social responsibility and corporate accountability. Our expectation that individuals will act in a socially responsible manner is not removed by the process of incorporation. The directors' obligation to act for the benefit of the entity and the shareholders collectively includes the obligation to insure the entity does what society expects. If a corporate entity has responsibilities in the community in which it operates because of its size and power, then it is not only appropriate, but necessary that directors consider these responsibilities in their decision-making. As part of a director's duty of care he needs to insure that the entity is able to meet its obligation of good citizenship. For example, it may be that all large economic entities should have not only an audit committee (and, if a publicly traded corporation, a nominating committee) but also a public policy committee charged with identifying the specific social responsibilities of the corporation and monitoring their fulfillment.

This fiduciary approach places an obligation to monitor corporate behavior on the directors. Directors as fiduciaries to the corporation must exercise appropriate due care under the circumstances to provide compliance with the law, and failure can lead to liability. These fiduciary obligations can be enforced not only by shareholders, but by the public through both criminal and civil actions. Directors, of course, are not insurers of corporate behavior. They should not be held vicariously liable for negligent or criminal acts of corporate agents, but they do have a duty of care that extends to all aspects of corporate activity. Because directors are the representatives and stewards⁵³ of the owners, the public has a right to look to the directors when a corporation fails to meet its obligations.

The fiduciary underpinnings of corporate conflict of interest

53. The Business Roundtable statement includes the following: "The directors are stewards — stewards of the owner's interest in the enterprise, and stewards also of the owner's legal and ethical obligations to other groups affected by corporate activity." See 33 BUS. LAW. 2083, 2096 (1978). An English commentator expressed a similar concept: "Now our corporation laws put great emphasis on the fiduciary duties of directors . . . [A director] owes only one duty, honesty to the interests of his company." Brown, *An English Perspective*, in COMMENTARIES, *supra* note 2, at 148.

cases also help to resolve the corporate governance problems involving the composition and structure of the board of directors. First, the fiduciary concept encourages the use of outside directors. The desire for nonmanagement directors on the board and for a separate nominating committee composed of outside directors is at least in part a response to conflict of interest concerns. In any conflict-of-interest case involving officers, the directors making the decision should be as independent as possible. The role of the board of directors in takeover bid situations⁵⁴ and in determining whether or not to recommend dismissal of a derivative suit⁵⁵ are contemporary examples where the role of outside directors is generally recognized as crucial. The existence of a nominating committee composed only of outside directors may become an important test of independent judgment in actions by directors of publicly traded corporations.

In this context the desirability of outside directors is determined by the size and complexities of the corporation. The greater the economic impact of the corporate entity, the greater the need for outside directors. This need is both to reduce the conflict of interest that exists when all directors are employees and members of management, and to provide a diversity of experience and background. Publicly traded corporations should have a substantial number of outside directors because of the large number of shareholders. Quasi-publicly traded corporations which have a significant number of employees, or affect the community in other significant ways should also have outside representation, as should the boards of major nonprofit corporations. Composition of boards of directors should mirror the complexity and diversity of the corporation's activities; no one pattern is appropriate.

Finally, the emphasis on the corporate entity argues against the use of constituency directors. Directors elected or appointed to represent particular constituencies have a splintered allegiance, and can create inherent conflicts of interest.⁵⁶ This is as true of employee representatives on boards as it is of student or alumni representatives on nonprofit education boards. The goal should not be to "balance

54. For a case with strong reliance on good faith and the business judgment rule, see *Painter v. Marshall Field & Co.*, 386 F. Supp. 1168 (N.D. Ill. 1980).

55. *E.g.*, *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979). *But see* *Maldonado v. Flynn*, 413 A.2d 1251 (Del. Ch. 1980), where the court said even an independent board cannot foreclose a derivative suit.

56. Conflict of interest could also be alleged where a director promoted the interests of only a single group of shareholders. It is also theoretically possible that a director's allegiance to all stockholders could conflict with his duty to the corporate entity, but such a conflict seems unlikely.

conflict of interest," but to select individuals who recognize their allegiance to the enterprise itself.

CONCLUSION

Many of the key problems subsumed under the rubric of corporate governance were identified nearly fifty years ago. This Essay has attempted to identify the contemporary corporate governance issues of the quasi-publicly traded corporation and the role of the corporate director, and to focus the analysis of these issues on the role of the securities markets and evolving fiduciary standards for directors. Yet the target is still moving, and much work remains to be done.